REAL ECONOMY

MONTHLY ECONOMIC AND POLICY REVIEW, ISSUE NO.20, JUNE 2011

GOVERNANCE

New elections, old problems. In our State of the Country Report (http://www.expert-grup.org/library_upld/d265.pdf) we elaborated in much detail on the dividing lines crossing Moldovan society. Now, more than one year since publishing the Report, we have to confess these dividing lines are alive and well. In this context, the capital city and Gagauz autonomy are the most eloquent examples. In the former case the electoral contest turned out very tight (and this is despite the fact that Chisinau has never been Communists' fortress) but lacked meaningful substance; in the latter, it showed continued drift of the autonomy away from the national political process with most of 'winnable' electoral contenders running on independent platform with no connections with national political parties. While certain parties do not shy away from manipulating and capitalizing on these divisions, there are growing question marks whether country and society can bear any much longer in this way...

Furthermore, freedom of opinion and open electoral process alone are neither a goal in itself or a recipe for success (sic!). For both ruling and opposition parties have not matched their zeal for politicking with consistency in implementation of political and economic reforms. Therefore, the comparisons with the post-Orange revolution Ukraine have become manifest while Moldova's western friends show growing signs of uneasiness with proliferation of stalemates in different areas of reform.

Both the ruling coalition and opposition forces have to get message from these elections right: First, they need to talk to each other in civilised manner and focus on issues of urgent and common interest; second, the reform process should be put back on track as soon as possible before the external political and economic environment does not turn bleaker.

GDP

The economic growth of 8.4% in Q1'11 was outstanding, even though Expert-Grup was more optimistic than the Government when revising upward the forecast for 2011 in May this year. An overview of the general situation in the CEA countries suggests that this is completely in line with the regional trends, most of the countries reaching impressive growth: Belarus – 10.9%, Romania -6.7%, :Latvia – 10.1%. However, the evolution of the rest of EU is not homogenous, the economy of some countries, including host countries of Moldovan emigrants, slowing down and even declining in Q1'11.

No need to say that households' consumption remained the main driver of growth, fueled by increased amounts of remittances in Q1'11 (by 20%). Consequently, net taxes on goods rose by 17.9%, reducing the share of

In this issue:

- New elections, old problems;
- Outstanding growth in Q1'11;
- Commercial banks reviving their lending activity;
- First signs of 'recovery' on the labour market?;

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__REAL ECONOMY__ is a monthly economic review tracking the most important policy and economic evolutions. Its readers are policymakers, CEOs of domestic and international companies and banks, representatives of the international institutions and foreign embassies, political parties and economic journalists.

Used acronyms and abbreviations:
y-o-y - year on year; q-o-q - quarter on quarter; Q4'07 – fourth quarter 2007; Jan'09 – January 2009; NBS – National Bureau of Statistics; NEA – National Employment Agency; NBM – National Bank of Moldova; EG – Expert-Grup; MDL – Moldovan leu (national currency); p.p. – percentage points;

__EXPERT-GRUP__ is a Moldovan policy think-tank whose mission is to create a working environment in which free and non-trivial thinking thrives in order for the institution to be a leading source of unbiased economic analysis and to effectively advocate for innovative ideas and solutions to the economic problems that Moldova encounters along its path of economic transformation, societal development and European integration.

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This publication has been supported financially by Moldova Soros Foundation as part of the project "Promoting Good Governance through Independent Economic Analysis and Forecast" The opinions and conclusions presented in this document belong exclusively to the authors and are not necessarily shared by Soros Foundation Moldova.

GVA in GDP that is an indicator on the quality of growth. Despite GVA rose in all economic sectors, only in trade and industry this was high enough to keep its weight in GDP.

Table 1. Evolution of GDP expenditure and production elements, Q1'11 vs. Q1'10

	y-o-y growth, %	Contribution to growth, p.p.
GVA	6.6	5.5
Net taxes on goods	17.9	2.9
Final consumption	9.7	12.2
Gross capital formation	32.5	4.2
Net export	-	-8

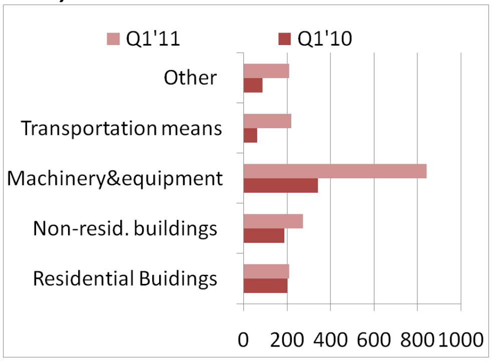
Source: NBS

The economic perspectives seem to be optimistic as further suggested by the private sector's proceedings. In Q1'11 local companies, more convinced of the stability of the demand on the market, decided over the expansion of their activity and invested in equipment, so that gross capital formation rose by 32.5% (Table 1). However, the situation seems to be not as attractive for the foreign investors, the external sources of financing declining.

No doubt the old economic model is the only short- and mid-term solution for Moldova. The role of the Government is to take advantage of the inflows of remittances and improve the business climate, so that to promote investment as excessive reliance and comfort given by reduced pressures in the economy cannot be a sustainable long-term strategy.

REAL SECTOR

Figure 1. Breakdown of Investments in LTTA for Q1'2010 and Q1'2011 (mil. MDL)

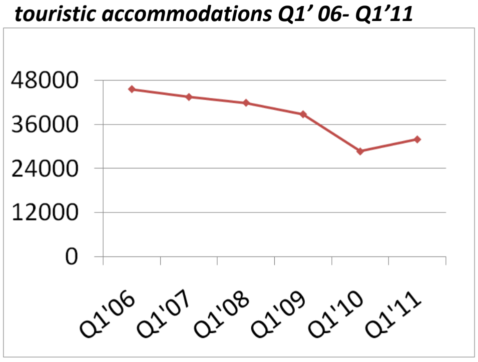


Source: NBS

The 32% y-o-y increase in investments in long-term tangible assets (hereinafter LTTA) suggests that the economic performance is bouncing back to the pre-crisis level. This trend was supported mainly by the revival of the local business activity, since foreigners are still reluctant to invest and to extend their businesses. The breakdown of the aggregate investments in LTTA proves that the components have a heavily unbalanced evolution. The overall growth was primarily due to a 60% increase in the resources invested in machinery and equipment and 73% increase in those invested in transportation means (Figure 1).

After hitting the rock bottom in Q1'2010 with a record low number of tourists placed in collective touristic accommodations, the indicator depicts a slight recovery, registering an increase of 11.3% y-o-y. The trend is especially encouraging considering that their number has been constantly dropping in Q1 for the past 5 years. However, it's worth bearing in mind that the pre-crisis number of tourists in 2007 was about 36% larger than the one registered in Q1'2011 (Figure 2).

Figure 2. Tourists placed in collective touristic accommodations Q1' 06- Q1'11



Source: NBS

Although not as striking, the performance of agricultural sector during Q1'11 has also depicted some positive evolution. The agricultural output increased by 8.3% y-o-y. Although the animal production accounted for roughly the entire increase (8.4%), the prospects of the livestock production might have a significant impact on the performance of food industry as a whole and output of animal production in particular. The investments necessary for complying with the new regulations might drive out of business some producers of livestock and eggs. In fact, many entrepreneurs in that field might go bankrupt within a year unless the government offers them the funds necessary for acquiring the equipment.

During Q1'2011 the industrial output has registered an overall increase of 8.5% y-o-y, a figure that marks a return to the pre-crisis growth dynamics. Just like in the previous quarter, the positive evolution was achieved mainly thanks to the increase in mining and quarrying' output (26.5%) and processing industry's output (12.6%). Yet, considering the contribution shares, the processing industry had a more significant influence on the cumulated growth. Breaking down the processing industry it can be mentioned that remarkable evolutions were depicted in the following sectors: medical equipment and instruments (70%), metallurgical (60%); equipment and machinery (40.2%). On the other hand, the production and distribution of electricity and heat have slightly counterbalanced this performance registering a 3.7% decline.

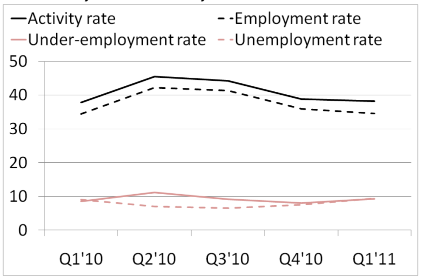
Unfortunately the poor performance of the energy sector is mainly explained by the rapid depreciation of the outdated equipment. However, the government is currently considering scenarios that imply the privatisation of the energy distributing enterprises. This particular course of action will most likely revive the performance in the energy sector, but only in the long run.

HOUSEHOLDS

After almost three years of constant worsening of activity and employment rates, the long awaited recovery on the labour market has come, though difficult to call it recovery, but rather stabilization. Employment rate has increased by 0.2 p.p, trade, hotel and restaurants sector explaining almost entirely the rise of employed population, although some insignificant positive changes took place also in industrial, transport and communications and public administration sectors. At the same time, employment in agriculture continued its decade-long shrinking trend, related to the low performance of the sector that does not have a prosperous future in its current condition. Additionally, employment in construction shrank by around 15%.

However, slight increase in available jobs has not reduced the pressures on the labour market, and unemployment rate continued to increase, reaching 9.4% in Q1'11. The situation seems to enter a recovery trend in the second quarter, as data on registered unemployed started to decrease in April and May this year. Meanwhile, under-employment rate continued to rise, reaching new high – 9.3% (Figure 3).

Figure 3. Main indicators on the labour market, 2010-2011, %



Source: NBS

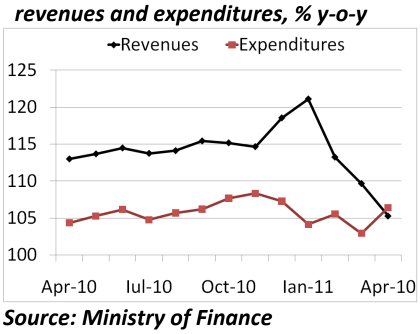
The improvement on the labour market is also supported by the evolution of wages that increased in real terms on average by 3.3% in Q1'11. The most significant increase was in agricultural, mining and quarrying and wholesale and retail trade. Wages in the most competitive sectors: financial activities and transport and communication have moderated their growth recently. At the same time, the very slight increase in nominal wages in health sector that do not cover at least the inflation rate is concerning and most probably the wages in the sector will need to be revised.

Remittances grew by 20% in January-April y-o-y, largely explaining the rise in consumption in Q1'11 and already an increase in natural persons' deposits by 14% y-o-y in May. The increase in remittances was registered despite the decline in number of people working abroad by 6.2% in this period, indicating over a raise of average emigrants' earnings.

PUBLIC FINANCE

In April 2011, the growth rate of budgetary expenditures has exceeded that of revenues by 1.13 p.p for the first time during the year (Figure 4). While the absolute difference is not significant it might be as well, trendsetting. In fact, the curve depicted by the revenues' growth rate, has been constantly decreasing ever since January 2011. So far, the increased excises rates (on alcoholic beverages, tobacco and excises for imported cars) have not been able to boost the revenues' growth rate. The breakdown of the revenues registered during the first 4 months of 2011 shows that both the VAT and excises amounts have increased by 19% and 26% respectively as compared to the respective period of 2010.

Figure 4. Evolution of state budget revenues and expenditures, % y-o-y

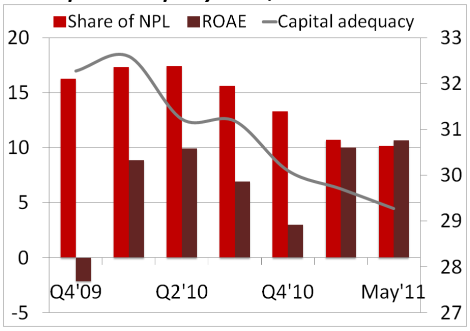


Source: Ministry of Finance

As regards the expenditures, the most significant change was registered in the agricultural expenses that have decreased by roughly 61% and 'social assistance and insurance' expenses that have increased by 12% y-o-y.

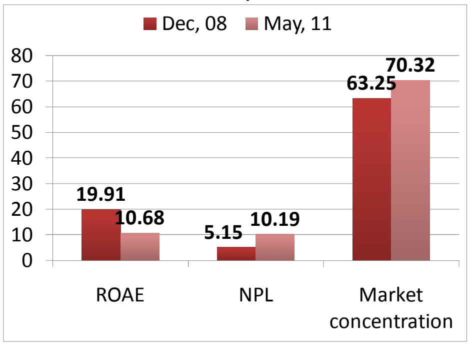
FINANCIAL SECTOR

Figure 5. Share of non-performing loans in total banks portfolios, banking profitability and capital adequacy ratio, %



Source: NBM

Figure 6. Return on average equity, share of non-performing loans in total loans, market concentration indicator[1],%



Source: NBM

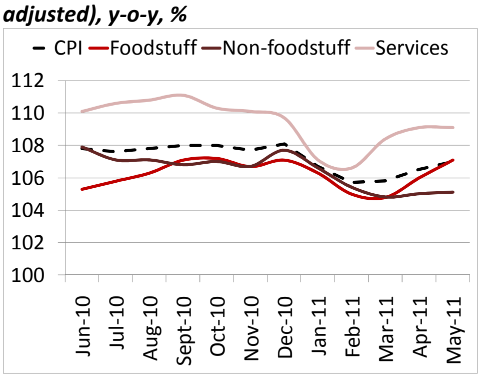
Banking sector is gradually switching from lending to the Government to lending to the private sector. In the first 5 months the total nominal demand of banks for T-bills in the weekly Government securities auctions decreased by 32.4% in comparison to the same period of the previous year. This decreasing appetite for T-bills was paralleled with much higher interest rates for such securities, given the gradual monetary policy tightening. Hence, this is another sign of a dynamic economic recovery taking ground, supported by improving expectations of the banking sector regarding the country's macroeconomic situation.

The robust economic recovery is mirrored by the constant improvement of the banking sector situation. The quality of banks' loans portfolio is increasing slowly, but constantly, as revealed by the decreasing share of non-performing loans. The resurgence in lending activity expanded the banks' balance sheets, decreased capital and liquidity ratios and improved profitability indicators. Nevertheless, the banking sector remains abundant in liquidities and well-capitalized (Figure 5). Despite the robust recovery, the banking system is far from reaching the pre-crisis level, as it struggles with a series of structural issues. Thus, the share of non-performing loans is still twice as big as the level of the end of 2008, the banking profitability is much lower and the entire sector remains highly concentrated, more than before the crisis (Figure 6).

The Moldovan banking sector lending activity took firmly on a recovery path which is likely to continue during the next months. Such a robust lending expansion, on the one hand, levers the economic growth by providing the real economy with additional liquidities for fostering the investment activity. On the other hand, it fuels the inflationary pressures which can harm the long term economic development.

MONEY AND PRICES

Figure 7. Evolution of CPI, industrial producers' prices index (for domestic market) and money in circulation (seasonally adjusted), y-o-y, %



Source: NBM, NBS and EG calculations

In May, the monthly inflation rate increased by 0.6%, with the biggest contribution of communal services and non-food products. Thus, due to the new tariffs approved by NARE, the electricity supply became more expansive by 6.4%; the revival in construction sector fueled the prices for construction materials by 2.2%; the seasonal factor made the prices for touristic services higher by 3.3%. Additionally, the second round effects of previous increases in energy prices drove up the prices of drugs (+1.0%) and railway passenger transport services (+5.3%).

The y-o-y inflation climbed to the 7.0% level in May, from 6.5% in April, on the grounds of a mix of supply and demand-side pressures. The highest contribution to inflationary overshooting had the services sector (Figure 7). According to the central bank, the main culprits of the current inflationary overshooting are surging regulated prices, imported inflation and increase in production costs. However, besides these factors, the price level is also led by demand-side pressures (robust revival in lending activity, higher inflows of remittances), which strengthens domestic consumption. The persistence of non-monetary inflationary pressures is confirmed by still strong discrepancy between the headline and core inflation.

Given the persisting monetary inflationary pressures, NBM is tilting gradually to the hawkish side. In May, the central bank raised its reserve

[1] The share of 5 biggest banks' assets in total banking assets.

requirements rate from 11% to 14%, which is the second increase this year (after 3p.p. increase in January). Such a strong reliance of NBM on this monetary policy instrument, while keeping almost intact its main policy rate, is explained by (i) the fact that it is the considered the best “hummer” to strike the “monetary nail” (CPI), given the much slower transmission process related to the REPO rate; and (ii) the central bank’s attempt to influence the liquidity *level,* while keeping its *price* almost unchanged and, in this way, to tackle the inflationary pressures without hampering the economic recovery.

Foreign trade

Foreign trade puts crisis memories behind. Foreign trade continued its surprisingly strong growth. Both exports and imports posted healthy annualised growth rates of 63% and 43.9%, respectively, in January-April 2011. Both exports and imports extended the lead over levels achieved in the highest pre-crisis period of 2008. The pace of growth is also amongst the highest in the region;

On aggregate, data shows that foreign trade’s increase is propped by expansion of volumes of traded goods and not by the fact that Moldovan exports have become more expensive. On the ground this expansion is explained by recovery growth in some traditional sectors (for instance, metals), strong ‘exploratory’ growth to markets other than the EU and CIS ones (Turkey is the most startling example), as well as rising of certain sectors, such as “machinery and transport equipment”[2].

This positive trend should not make the trade watchers overtly sanguine. Despite the stronger exports’ growth the trade deficit is still deeper in red in comparison with one year ago. At the same time ‘pockets of brilliance’ such as machinery sector are not strong enough to drag the foreign trade out of red or allow us to assert that there is new ‘trade paradigm’ in the making as domestic consumption continues to drive the growth in Moldova.

[2] http://expert-grup.org/library_upld/d348.pdf

Statistical Appendix

Table 2. Moldova: key short-term economic indicators

	Aug'10	Sep'10	Oct'10	Nov'10	Dec'10	Jan'11	Feb'11	Mar'11	Apr'11	May'11
Industrial production growth rate, y-o-y, %	2.3	13.9	16.8	7.6	2.3	9.8	9.1.	3.7	n.a.	n.a.
Retail-trade growth rate, y-o-y, %	9.7	8.1	11.4	12.7	9.2	n.a.	n.a.	n.a.	n.a.	n.a.
Services to population growth rate, y-o-y, %	-1.4	3.0	6.1	7.2	6.6	n.a.	n.a.	n.a.	n.a.	n.a.
Merchandise exports, million USD	122.6	149.5	179.2	204.8	186.9	134.5	161.2	182.9	n.a.	n.a.
Merchandise imports, million USD	301.5	345.0	373.4	405.4	439.9	284.8	356.9.	457.5	n.a.	n.a.
Official reserve assets, million USD	1551.4	1619.3	1645.4	1610.9	1717.7	1744.5	1739.8	1793.4.	1918.4	1909.4
Registered unemployed, persons, end-period	46216	43329	41333	39943	40719	44170	50095	51204	48686	44719
Real wage growth rate, y-o-y, %	2.2	0.9	1.7	2.8	-1.0	2.3	5.4	2.2	n.a.	n.a.
Budget revenues growth rate, cumul. y-o-y, %	14.1	15.4	15.1	14.6	18.5	21	13.2	9.7	5.3	n.a.
Consumer prices growth rate, y-o-y, %	7.8	8.0	8.0	7.7	8.1	6.7	5.5	5.8	4.3	4.9
Nominal exchange rate, end-period, MDL/USD	12.20	12.02	11.81	12.12	12.15	11.98	11.99	11.90	11.69	11.67
Nominal exchange rate, end-period, MDL/EUR	15.43	16.34	16.36	15.96	16.10	16.44	16.53	16.82	16.87	16.60
Broad money (M2) growth rate, y-o-y, %	22.07	22.53	29.42	25.47	18.36	17.33	19.97	17.38	20.51	22.1
Central bank refinancing rate, end-period, %	7.0	7.0	7.0	7.0	7.0	8.0	8.0	8.0	8.0	8.0
Bank deposit rate, %	7.99	7.43	6.79	6.82	6.54	6.79	7.82	6.79	7.23	7.873
Bank lending rate, %	16.44	15.80	15.88	15.24	14.76	15.24	14.53	14.6.	15.05	14.59
Banks liquid assets, % of total assets	33.59	34.05	33.19	33.36	34.15	34.62	n.a.	33.2	n.a.	n.a.
Banks unfavorable credits, % of total credits	17.38	15.67	15.23	14.80	13.33	13.39	n.a.	10.73	n.a.	n.a.
Currency deposits, % of total deposits	49.00	48.88	48.32	47.92	48.45	48.55	n.a.	47.98	n.a.	n.a.

Source: NBS, NBM and EG calculations and estimates;

Table 3. Moldova: key long-term economic indicators

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Population, million (excludes Transnistria), end year	3.628	3.618	3.607	3.600	3.590	3.581	3.573	3.568	3.563
GDP, billion USD, current prices	1.662	1.981	2.598	2.988	3.408	4.401	6.055	5.403	5810
GDP per capita, USD at PPP	1761	1923	2126	2359	2559	2720	3004	2839	3088
GDP growth rate, y-o-y, %	7.8	6.6	7.4	7.5	4.8	3.0	7.2	-6.5	6.9
Private consumption growth rate, y-o-y, %	5.9	18.5	6.2	10.1	7.0	3.6	4.5	-7.9	9.0
Gross fixed capital formation growth rate, y-o-y, %	1.1	19.2	11.0	17.7	2.8	10.5	-7.8	-37.2	17.2
Industrial production growth rate, y-o-y, %	10,8	15.6	8.2	7,0	-4.8	-1.3	0.7	-22.2	7.0
Agricultural production growth rate, y-o-y, %	3.4	-13.6	20.8	0.8	-1.1	-23.1	32.1	-9.9	7.9
Share of industry in GDP, %	20.2	20.5	20.5	19.1	18.0	19.1	13.9	13.0	13.3
Share of agriculture in GDP, %	21.0	18.3	17.5	16.4	14.8	10.0	8.8	8.5	12.0
Merchandise exports, million USD	659.7	805.1	994.1	1104.6	1060.8	1373.3	1646.0	1321.5	1582.1
Merchandise imports, million USD	1037.5	1428.1	1748.2	2296.1	2644.4	3676.4	4866.3	3333.0	3855.3
Service exports, million USD	216.65	249.93	332.08	398.94	465.66	625.08	837.2	677.7	689.79
Service imports, million USD	256.99	294.26	353.05	419.68	487.64	631.16	824.72	701.8	770.10
Net foreign direct investment, million USD	83.6	73.64	147.8	190.86	234.16	522.04	691.49	112.0	198.9
Net work remittances, million USD	286.3	440.2	659.5	868.8	1119.0	1419.4	1795.8	1106.8	1253.3
Current account/GDP, %	-4.0	-6.6	-2.2	-8.1	-11.7	-15.2	-16.7	-8.6	-8.3
Official reserve assets, end-year, million USD	268.87	302.27	470.27	597.44	775.3	1333.7	1672.4	1480.3	1717.7
Total external debt stock, million USD	1816.5	1929.4	1881.8	2078.1	2528.9	3355.9	4106.1	4368.8	4618.1e
External debt/GDP, %	109.3	97.5	72.5	69.6	74.3	76.3	67.9	80.8	n.a
External debt/exports of goods and services, %	198.2	182.2	141.5	138.0	164.8	167.4	164.6	215.1	n.a
Employment rate, % of population aged above 15	53.3	47.5	45.7	45.4	42.9	42.5	42.5	42.8	38.5
Unemployment rate, % of economically active population	6.8	7.9	8.1	7.3	7.4	5.1	4.0	6.4	7.5
Real wage growth rate, y-o-y, %	20.9	15.4	10.1	6.8	14.2	8.0	10.2	9.0	0.7
Consumer prices, year average, %	5.2	11.6	12.5	12.0	12.8	12.4	12.8	0.0	7.4
General government balance, % of GDP	-2.2	1.0	0.4	1.5	-0.3	-0.3	-1.0	-7.0	-2.5
General government expenditure, % of GDP	31.5	33.1	35.1	37.0	40.1	41.8	41.6	43.5	40.8
Exchange rate, year average, MDL per USD	13.6	13.9	12.3	12.6	13.1	12.1	10.4	11.1	12.4
Broad money (M2) growth rate, y-o-y, %	30.4	24.4	44.8	36.7	12.2	47.3	18.3	-3.8	18.4
Central bank refinancing rate, end-year, %	9.5	14.0	14.5	12.5	14.5	16.0	14.0	5.0	7.0
Total commercial bank loans, % of GDP	27.9	28.5	30.3	30.2	33.6	40.2	39.8	41.4	37.2
Bank deposit rate, average per period, %	14.4	12.7	15.2	13.0	11.9	15.1	18.1	14.7	7.56
Bank lending rate, average per period,%	23.1	19.2	21.0	18.9	18.2	18.9	21.0	20.3	16.25

and estimates;